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DIRECTORATE OF
INTELLIGENCE

WEEKLY SUMMARY

Special Report

The Economic Consequences of the Indo-Pakistani War

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№ 605

24 March 1972
No. 0362/72B

Approved For Release 2005/01/11 : CIA-RDP85T00875R001500040012-5

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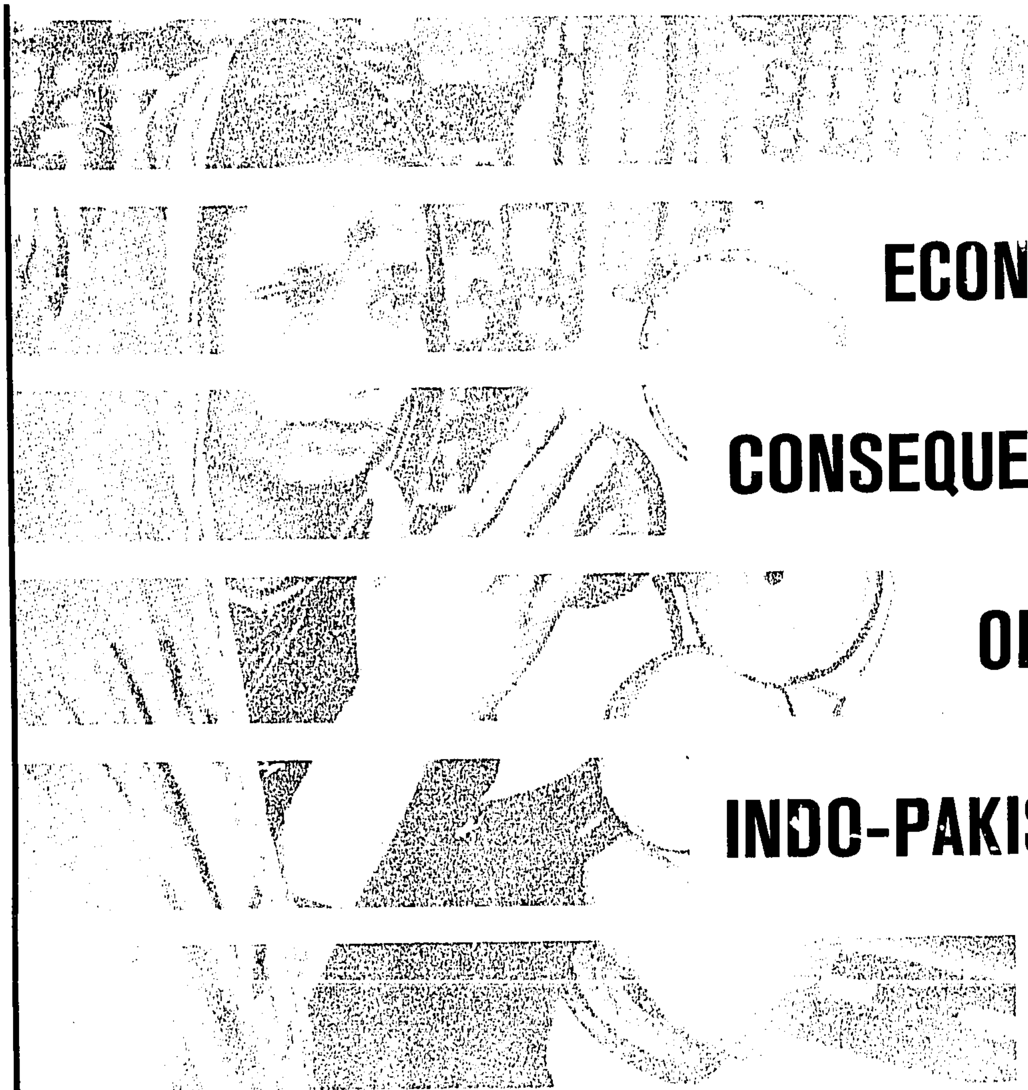

THE ECONOMIC CONSEQUENCES OF THE INDO-PAKISTANI WAR

The Indo-Pakistani war in late 1971 did not alter New Delhi's economic prospects significantly. Increased military expenditures were manageable, refugee costs have diminished, and the country's international financial position remains strong. On the other hand, the loss of East Pakistan's markets and the halt in foreign aid have created short-term difficulties for West Pakistan's economy, but its longer range prospects are fairly good. The new nation of Bangladesh faces formidable economic problems. As East Pakistan, it was one of the world's most populous and poorest nations. In the war's aftermath, extensive reconstruction will be necessary before Bangladesh can get back to even the poor, pre-war level of economic activity, let alone begin to think in terms of economic development.

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INDIA

New Delhi's short-term economic prospects, fairly bright before the war, have not been seriously dimmed. Foodgrain production was unaffected by the war. It has increased rapidly since 1966 and will hit record highs again this year as India has been favored by an exceptionally long period of good weather. Industrial production was in the doldrums when the war started, principally because of government investment policies, raw materials shortages, and labor and management problems, but prospects have not grown worse. The war has enhanced New Delhi's prospective export earnings by perhaps five percent by making possible substantial sales to Bangladesh. Most of these exports, however, will have to be financed by India for some time.

As a result of the war, India's military expenditures increased by about 20 percent, or roughly $225 million in fiscal 1971, which began on 1 April. New Delhi enacted new revenue measures to offset most of its war-related expenditures. Additional foreign exchange payments caused by the war were small: annual payments for military imports—approximating $300 million a year in recent years—probably were raised by only $20-25 million. This relatively minor foreign exchange drain was offset in part by refugee aid receipts in hard currency from Western donors because New Delhi supplied the refugees' requirements from domestic production. Refugee costs, which had been about $400 million before hostilities, fell off drastically after the cease-fire, as almost all of the ten million refugees returned home.

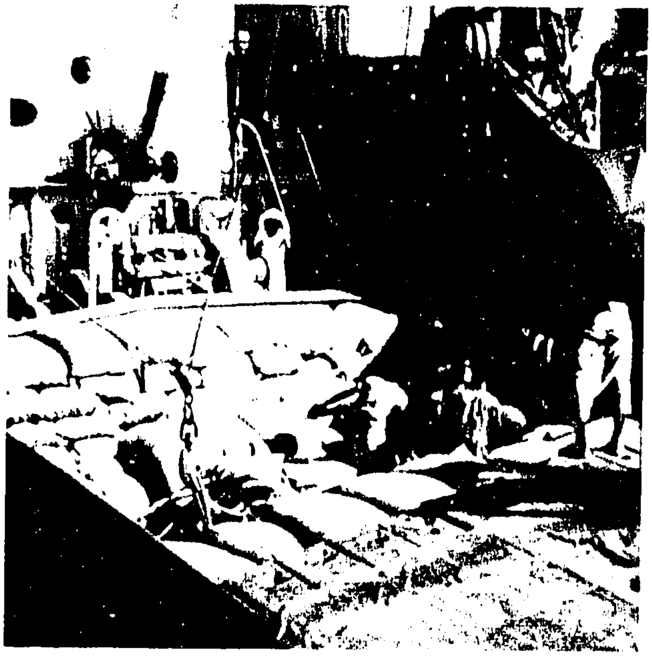
In the aftermath of the war, India has assumed a major share of Bangladesh's immediate economic aid requirements. New Delhi already has authorized $176 million in such aid. The aid has included $32 million for food and cash payments to returning refugees, and about $34 million to finance purchases of urgently needed commodities such as food, medicines, fuels, and industrial products. Other Indian loans to Bangladesh include $69 million for foodgrains, $14 million for railroad rehabilitation, and $14 million for civil aircraft and ships. Also included was a $13-million loan in hard currency to meet immediate foreign exchange requirements. Of the total aid, about $70 million is expected to be used during the current fiscal year with the remaining $106 million to be drawn in fiscal 1972.

India's export prospects are enhanced by the resumption of trade with what is now Bangladesh. This trade will consist largely of items previously traded between East and West Pakistan. Excluding products that are in short supply in India, West Pakistan's exports to the East Wing had averaged roughly $90 million annually during the two years before the war. There is scope for trade in other items, although the trade structure that eventually develops is likely to differ from what it was before partition in 1947. In addition to imports of manufactures, mainly consumer goods, Bangladesh probably will buy steel, coal, and some machinery from India. The extent of Indo-Bangladesh trade over the next year will depend heavily on New Delhi's economic aid. India's exports to Bangladesh probably will amount to over $100 million in fiscal 1972. It will be financed largely by commodity aid already authorized but not delivered during this fiscal year. Additional aid authorizations by India are likely, but they may be smaller because Bangladesh probably will be receiving economic aid from other nations as well.

During the war, the US suspended $88 million of unused aid that had been committed to New Delhi. The impact of this suspension has not yet been felt and could be delayed for a year or more because of substantial commodity aid remaining in the pipeline and because of New Delhi's substantial foreign exchange reserves. US aid in the pipeline amounting to $132 million was already covered by irreversible letters of credit. With the exception of a temporary suspension by Japan that was rescinded after the war, India's other donors did not withhold economic aid and have continued to provide assistance amounting to almost $600 million. The loss of US aid would deprive India of a major source of commodity financing needed to maintain current production levels. Over the past several years, US aid has provided about one sixth of New Delhi's commodity imports, including such critical items as fertilizers, nonferrous metals, and special steels.

In spite of its extremely favorable foreign exchange position, New Delhi has imposed additional restrictions on imports and has authorized a study aimed at identifying indigenous substitutes for a broad range of goods currently imported from hard currency countries. A possible expansion of India's trade with the USSR and East Europe, which is not conducted in hard currencies, is also being studied.

As a result of India's military victory, New Delhi is in an excellent position to take strong measures to accelerate economic growth in the short run. Prime Minister Gandhi's hand has been strengthened by her victory in recent state elections. She could raise more revenues to support development, for example, by taxing agricultural incomes, currently a prerogative left to the individual states. It is doubtful that accelerated growth can be achieved soon, if only because shortages of imported materials may worsen as a result of the recent restrictive measures.



PAKISTAN

Loss of East Pakistan and strained relations with the Western Aid-to-Pakistan Consortium have brought pronounced transitional problems for Islamabad's economy. West Pakistan's long-term economic prospects are more favorable than those of India, however, given political stability and moderate policies. Loss of the East Pakistani market and foreign exchange earnings will be less important in the long run than the fact that Islamabad has gotten rid of its poorest, most densely populated and economically stagnant region, which promised to become a growing claimant on foreign aid receipts and a declining net earner of foreign exchange. West Pakistan is basically self-sufficient in foodgrain production, has reasonably well-developed transportation and communications systems, and is able to draw on a sophisticated entrepreneurial class. An average six percent annual growth rate in the 1960s demonstrated that, with financial help from abroad, West Pakistan can marshal its resources fairly effectively.

West Pakistan's rapid economic growth during 1961-70 rested heavily on large aid inflows. These reached a peak of $474 million in 1968. About two thirds of the $5.5 billion in aid received by Islamabad during these years was used in West Pakistan, a factor in its superior performance compared with East Pakistan. The "green revolution" in agriculture in the late 1960s resulted in large production gains and virtual self-sufficiency in foodgrains. Industrial development also was impressive, with average production gains of nine percent a year being registered in the 1960s.

Business uncertainty and weaknesses in some industries that depended on exports to East Pakistan will constrain somewhat West Pakistan's economic performance in the short run. Efforts to redirect trade have thus far been generally successful. Investors' confidence has been shaken by the regime's partial take-over of several industries, and activity in the engineering and construction industries will slacken because of weak investment demand. In addition, public investment activity that was disrupted by the war now is apparently being held down by budget difficulties. Agriculture will be less affected by the recent crisis, but a lack of rain has put an early damper on prospects for a good wheat harvest this year.

Shortages of imported goods also will restrict West Pakistan's economic growth. Limited prospects for Islamabad's export earnings and foreign aid receipts, together with its modest foreign exchange reserves, point to substantially reduced import capacity in fiscal 1972 and to only a partial recovery in 1973. Progress in redirecting exports to new markets probably will permit West Pakistan to maintain, but not significantly increase, total exports during this period. Foreign aid receipts, on the other hand, are expected to drop sharply because of the aid cutoff a year ago. The Western Aid-to-Pakistan Consortium has tentatively agreed on a debt moratorium through June 1973, and new assistance probably will be forthcoming soon. Even if foreign exchange reserves are drawn down appreciably and a moderate amount of stop-gap commodity aid is forthcoming, West Pakistan probably would not be able to import as much during this fiscal year as last.

Longer term growth prospects depend mainly on moderate government policies and on the response of foreign countries to West Pakistan's needs. Western nations would be more likely to resume aid extensions and negotiate a long-term debt relief program if Islamabad were to eschew large-scale rearmament and radical economic policies. Political and economic moderation is also needed to restore confidence among domestic businessmen and farmers.

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BANGLADESH

The new nation of Bangladesh faces formidable economic problems. It has the world's eighth largest population—about 75 million—and one of the lowest average per capita outputs—roughly $65 annually. During its 24 years as East Pakistan, output grew slowly and living standards stagnated. For more than a decade the area has been unable to grow enough food for its people. The civil war and the war with India have left the transportation and distribution system in ruins.

Economic prospects for Bangladesh are grim, both for the immediate future and over the longer term. At least several months will be needed to restore even a semblance of economic normalcy. The return from India of an estimated ten million refugees has strained food and other essential supplies, and the establishment of moderately effective government services will be difficult even with Indian assistance.

The long-term economic development of Bangladesh faces immense obstacles. Natural resources are few, financial reserves are non-existent, and scarce technical and managerial skills have been lost with the departure of most West Pakistanis. Little slackening in the country's rapid population growth can be expected for many years. The government is an unknown quantity: will it be sufficiently stable and constructive in its economic policies to make good use of such resources as the region can obtain from abroad?

At the moment, Dacca clearly is strapped for cash. There was a heavy flight of capital to West Pakistan throughout 1971, and Islamabad took steps to keep Pakistani funds in foreign banks from falling into Dacca's hands. The economic disarray arising from the war, furthermore, has complicated normal tax collection procedures. At the same time, the pressure for increased government outlays is mounting because of reconstruction and refugee needs. The government, however, will gain a significant source of new funds as it implements the nationalization goals announced early in January and as increased foreign aid receipts become available.

Despite the war's disruptions, foodgrain shortages were averted initially because private stocks were available and about ten million refugees fled into India. With the return of the refugees, Bangladesh needs an estimated 200,000 tons of imported foodgrains a month this year. Over the longer term, moreover, the country probably faces greater food deficits than in recent years. The neglect of crops during the fighting and the lack of seed and fertilizer are expected to reduce

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the all-important rice crop by an appreciable margin. Foreign countries probably will send additional foodgrain supplies, but distribution will be difficult, particularly to traditionally deficit areas. In the long run, only massive foreign investment holds any promise of permitting foodgrain production to keep pace with population growth.

The new nation's export earnings will be affected heavily by how trade with India develops and by trends in the world jute market which takes about three quarters of Dacca's exports. Jute manufactures face competition from India and from synthetics. Bangladesh will need sharply higher imports in the next year or two if it is to undertake its most pressing reconstruction and rehabilitation tasks. Because export earnings probably will remain below normal for some time, the area's foreign aid requirements clearly will exceed the roughly $150 million it had been receiving annually as a part of Pakistan. Dacca has said that it is seeking $2-3 billion in relief and reconstruction aid, although it is impossible to say how much of this will be forthcoming.

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